

Advocates Aim to Preserve Like-Kind Exchange in Tax Reform

by Emily L. Foster

Practitioners and industry advocates aim to preserve the coveted like-kind exchange tax-deferred treatment that could be threatened if Congress considers revenue-raising ideas proposed by former House Ways and Means Committee Chair Dave Camp.

Camp's Tax Reform Act of 2014 lowered individual and corporate rates and paid for it with more than 200 revenue raisers that were vetted and priced. Although Camp's draft plan didn't lead to comprehensive tax reform, tax observers believe that Camp's proposals will continue to be the go-to source to offset corporate tax rate reductions in tax reform efforts in Washington.

According to Steven M. Rosenthal of the Urban-Brookings Tax Policy Center, Congress will likely return to a more conventional approach of "cutting rates and offsetting some of the revenue lost by closing some loopholes," rather than comprehensive tax reform. He predicts that the destination-based cash flow tax proposal "will come to an end mainly because the retailers are pretty loud and influential." He added that "the trouble is that we've squeezed a lot of loopholes out of the code, and so the few that are left often have very fierce advocates and the like-kind exchange is one."

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The House GOP tax reform blueprint is silent on like-kind exchanges, but with full expensing of capital expenditures, except land, section 1031 supporters anticipate that policymakers will reason that section 1031 is no longer needed. Thus, proponents continue to lobby for retaining like-kind exchanges in tax reform.

Bradley Borden of Brooklyn Law School noted that section 1031 has been on the chopping block in many tax reform proposals but continues to

survive, adding that "if the past is any predictor of the future, then it won't be repealed." But it's hard to predict what Congress will do, he said.

President Trump's one-page tax reform plan calls for eliminating tax breaks for special interests but offers no details to allay concerns about the future of like-kind exchanges.

Potential Revenue Opportunities

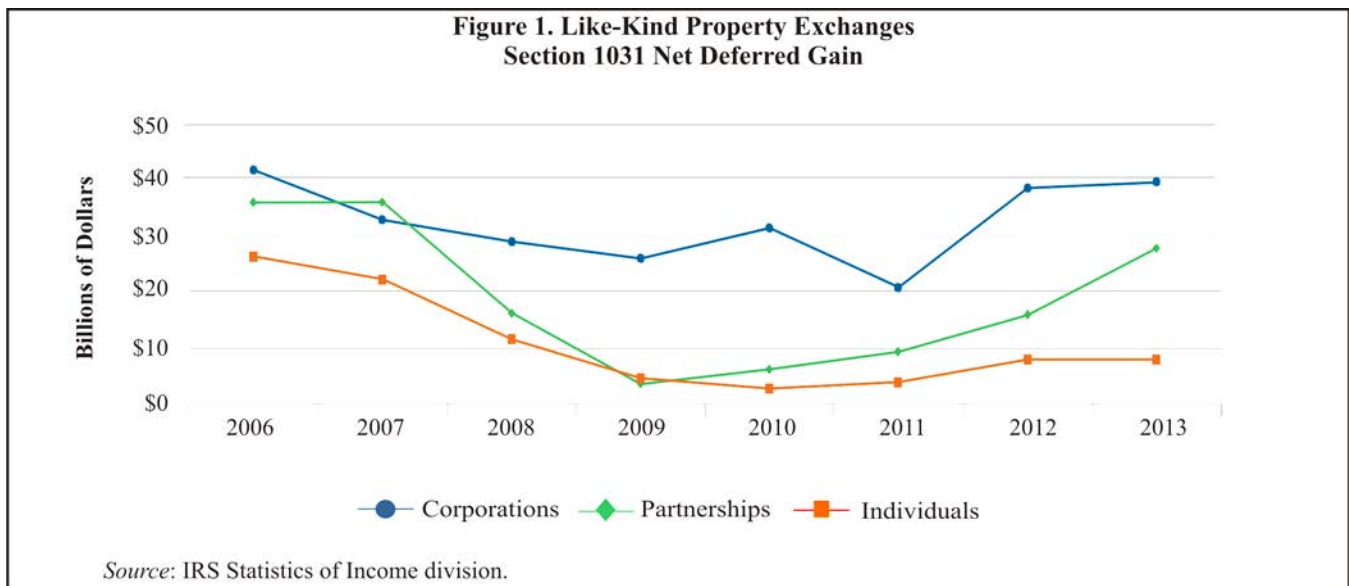
Camp's top revenue-producing business tax reform provisions emphasize delayed expensing — reform of the accelerated cost recovery system; amortization of research and experimental expenditures; and amortization of specific advertising expenses. The plan would phase out and repeal the deduction for income attributable to domestic production activities; repeal the last-in, first-out method of inventory; modify net operating loss deductions; and repeal like-kind exchanges.

If Congress shifts toward full expensing in tax reform, Camp's amortization-related proposals become irrelevant, leaving fewer options on the table.

Susan E. Seabrook of Buchanan Ingersoll & Rooney PC said practitioners who work with financial institutions and insurance companies assume that Congress will look to the Camp draft in search of revenue. Insurance companies are focused not only on the general revenue raisers, such as like-kind exchanges, but also on the provisions targeting the insurance industry, she said. Because Camp did much of the groundwork, practitioners believe that Congress, rather than reinventing the wheel, might pull some provisions off the shelf, she said.

Tony M. Edwards of the National Association of Real Estate Investment Trusts (NAREIT) told practitioners, "If you haven't already, go through the Camp plan, because it might come back." NAREIT has been looking at past proposals because "you never know what's going to be rushed in to pay for something else," he said, speaking at a recent NAREIT conference in La Quinta, California.

Given that the administration's tax plan is premised on economic growth spurred by tax reductions, Seabrook warned that simply dropping



one or more of the Camp revenue raisers into the tax reform plan could have unintended consequences for some sectors of the economy.

In the January tax expenditures report, the Joint Committee on Taxation estimated a \$90.2 billion revenue loss for the gains deferred on like-kind exchanges for fiscal 2016 to 2020, with \$59.1 billion for corporations and \$31.1 billion for individuals (including passthroughs). For fiscal 2017 the JCT estimated revenue losses of \$11.4 billion for corporations and \$6 billion for individuals.

Of the total \$74.4 billion of section 1031 deferred gains (losses) reported in 2013 on Form 8824, "Like-Kind Exchanges," corporations represented 52.5 percent compared with partnerships at 36.9 percent and individuals at 10.6 percent, according to data from the IRS Statistics of Income division.

According to a 2014 Treasury analysis, real estate transactions in 2007 accounted for nearly 90 percent of section 1031 deferred gains for partnerships compared with about 40 percent in 2010. During that period, those gains (losses) deferred by partnerships "dropped dramatically from \$35.6 billion in 2007 to only \$6.1 billion in 2010 due to the effects of the recession on real estate," the report said. By 2013, as the real estate market continued its recovery, that amount increased to \$27.5 billion, according to SOI data.

Corporations primarily have used like-kind exchanges for replacing their vehicle fleets, and "banks are thought to be significant users . . . in the context of vehicle leasing programs," according to Treasury's analysis.

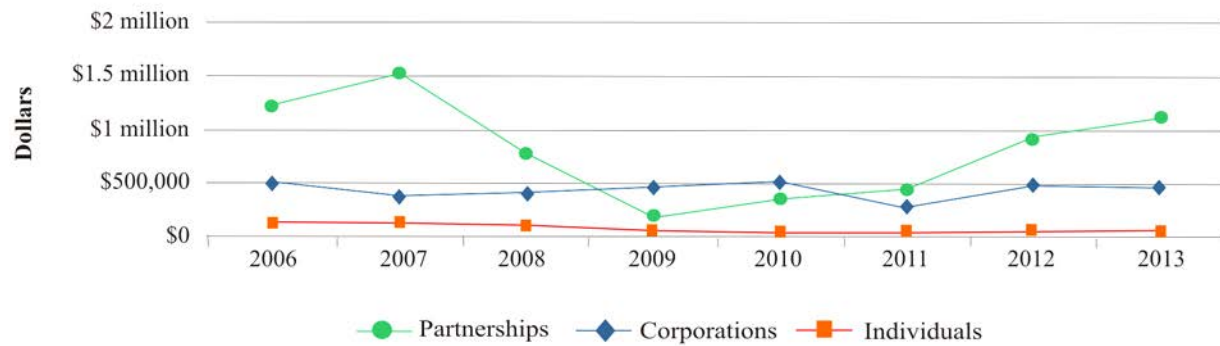
Long-Lived Like-Kind Exchanges

For nearly 100 years, individuals and businesses have benefited from section 1031 when they swap a piece of real estate or personal property (with exceptions including stocks, bonds, and partnership interests) held for use in a trade or business or for investment with a like-kind replacement. The rules allow deferral of capital gains when the proceeds of an asset sale are rolled over into the purchase of a similar asset, thereby reducing tax on capital income.

For relinquished property transferred in a delayed exchange, gain or loss may be recognized if the taxpayer actually or constructively receives money or other property before the taxpayer actually receives like-kind replacement property. Thus, many exchanges involve a qualified intermediary that acquires the relinquished property from the taxpayer, transfers it to another party, acquires the replacement property, and transfers that to the taxpayer.

Extensive lobbying efforts have thwarted numerous attempts by Congress and the White House to either repeal or curtail the coveted deferred tax treatment of like-kind exchanges.

**Figure 2. Like-Kind Property Exchanges
Section 1031 Net Deferred Gain Per Form 8824**



Source: IRS Statistics of Income division.

Average based on Form 8824 data on total deferred gain (loss) and the number of forms filed with a reported gain (loss).

The Federation of Exchange Accommodators (FEA), a professional trade association for QIs that calls itself “the voice of the 1031 industry,” has been working with other organizations and lobbyists to raise lawmakers’ awareness of the importance and economic benefits of section 1031. In September 2016 one lobbyist said, “Coming off of the Camp draft, people want to be more proactive.”

The Obama administration proposed restricting section 1031 like-kind exchanges in every budget request since 2014. In its fiscal 2017 budget proposal, the administration capped the section 1031 benefit at \$1 million per taxpayer per year for all property, and fully excluded specific kinds of personal property — art and collectibles. The JCT estimated the proposal would generate \$37.1 billion over 10 years.

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In 2013 the average total deferred net capital gains on like-kind exchanges reported on Form 8824 were about \$1.11 million for partnerships, \$444,000 for corporations, and \$36,000 for individuals. Those amounts may differ on a per-taxpayer basis because some companies file multiple forms rather than one summary form for all like-kind exchanges.

The average net deferred capital gain for partnerships declined during the recession nearly 90 percent, from \$1.53 million per Form 8824 in 2007 to about \$175,000 in 2009.

To Repeal or Not to Repeal?

Proponents for repealing section 1031 contend that it disproportionately benefits wealthy taxpayers, distorts investment decision-making within and across industries, causes economic distortion by overinvestment in like-kind property, and has led to complex transactions and costly taxpayer administration.

Rosenthal said he supports repealing section 1031 because it departs from the income tax norm that realized gains should be taxable. He said that generally, “it takes a sale or exchange before appreciation is recognized on your tax return, but we’re even more generous by excluding like-kind exchanges, which are principally real estate.” As real estate is exchanged to defer the gain and rolled over, the taxpayer could eliminate the gain if the basis of the replacement property is stepped up on death, Rosenthal said. But repealing section 1031 could be tougher politically, he said, noting that a large like-kind exchange industry comprising small real estate owners and QIs maintains a strong lobbying group that argues that “relief for taxes on real estate is good for America.”

Roberta F. Mann of the University of Oregon School of Law said she doesn't object to Congress repealing section 1031 because she generally favors trying to improve income equality through the code. Because section 1031 tends to benefit wealthier taxpayers, repealing it would tend to improve equality, she said.

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Suzanne Goldstein Baker of Investment Property Exchange Services Inc., co-chair of the FEA Government Affairs Committee, noted that "a broad spectrum of taxpayers, including individuals of modest means, small businesses, farmers, and ranchers," use section 1031. Those taxpayers build businesses and wealth through like-kind exchanges of residential rental properties, commercial properties, raw land, machinery, and equipment, she said.

Mann agreed with economists who say that eliminating the like-kind exchange deferred tax treatment could result in lower real estate prices, but she questioned whether that would be good for the economy. On one hand, it would benefit buyers of real estate, but lower prices could harm existing real estate owners, as well as other businesses that use section 1031 for rollovers of personal property, such as the rental car industry, she said. A 2015 macroeconomic study by EY found that repealing section 1031 could contract the economy by \$8.1 billion per year if the increased tax revenue is used to reduce the corporate income tax rate.

Diana Furchtgott-Roth of the Manhattan Institute argued that repealing section 1031 would be bad tax policy and result in less investment. Taxes should be levied on capital gains when taxpayers liquidate their asset, not because they want to exchange one asset for another, she said. If lawmakers are considering many ways to increase growth, such as expensing, why would they repeal section 1031? she asked.

Joseph B. Darby III of Sullivan & Worcester LLP agreed that like-kind exchange tax treatment is good policy because it permits and encourages companies to reinvest capital in their business without a "tax discouragement." The trucking and airline industries tend to trade up and invest more capital — they trade in old equipment for new, better, and more expensive equipment — rather than hold on to it because of the tax cost to upgrade, he said.

Although a predominant policy argument for section 1031 is that continuity of an investment shouldn't be taxed, the broad definition of like-kind property has extended the use beyond that justification, Borden said. Thus, narrowing the definition could be one way to raise revenue while still supporting the continuity in investment policy, he said.

Mann agreed that like-kind property for real estate transactions is "very broad" — anything used in a trade or business or held for investment — and could be limited to real estate similar in type or use to possibly raise revenue. For personal property, the definition is "quite narrow" — the properties exchanged must be within the same category, she noted.

At an April 5 House Agriculture Committee tax reform hearing, ranking minority member Collin C. Peterson, D-Minn., suggested changing the definition of like-kind property. In an environment of high land costs and low commodity prices, farmers have challenged section 1031 because the exchanges allowed aren't really like-kind, he said. A person can sell a shopping center and then purchase farmland without paying tax on the capital gain, "and that's driving up the price of land, which is too expensive already." Peterson suggested narrowing the like-kind exchange definition, for example, to farmland for farmland, which he said is what he thought it used to mean.

Christopher W. Hesse of CliftonLarsonAllen LLP, who testified at the hearing, responded that retiring farmers may want to go the other way — sell their farmland and purchase another type of property in a section 1031 exchange. But the primary concern is allowing section 1031 exchanges for a farmer trying to improve his position by selling a less desirable property to acquire a higher-quality or nearby property

without cashing out on the investment, he said. Hesse acknowledged that perhaps section 1031 exchanges are not as critical for equipment that falls under section 179.

If policymakers want to limit section 1031, they should consider what a person could and could not do to an existing piece of property tax free, Borden told Tax Analysts. For example, when an owner of raw land builds a building or removes a building, leaving raw land, no gain or loss is recognized, he said. Thus, an owner should be able to exchange raw land for developed property or the reverse tax free — otherwise the taxpayer won't put the property to its highest and best use, Borden said.

In some cases, section 1031 allows property owners to exchange partial interests that an owner otherwise couldn't do with the property tax free, Borden said, noting that a taxpayer can't convert a fee interest to an undivided interest or a fee interest to an oil and gas interest tax free, but could transfer those partial interests in a section 1031 exchange. If taxpayers should be treated the same whether they exchange like-kind property or continue an investment in property, then perhaps partial interests such as tenancy in common should be excluded from section 1031, he said.

100 Percent Expensing

The blueprint proposal radically changes U.S. business taxation from an income tax to a destination-based cash flow tax with full and immediate expensing of tangible and intangible property, but excludes land. According to Rosenthal, although the blueprint won't survive as is, policymakers will shift toward a cash flow approach like full expensing.

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Darby said that full write-off of depreciable assets is "economically substantially similar to the like-kind exchange." The 100 percent expensing proposal is a good idea because it would encourage reinvestment of capital broadly — not just with a rollover of property, he said. But "how

you fit 1031 into a system that allows full write-off of capital expenditures will be debatable, and we'll see where it comes out," he said.

The blueprint proposal for expensing is similar to bonus depreciation, Baker said. However, at 100 percent, it is likely that some states will not adopt it because it's too costly for them. Different treatment at state and federal levels adds complexity to tax reporting. Full expensing would result in a large, immediate recapture tax that along with any capital gains tax, may not be fully offset by expensing the new asset. Like-kind exchanges should remain available to smooth out that impact and remove any potential lock-in effect from business and investment transactions, according to Baker.

But if lawmakers proposed full expensing of capital expenditures similar to the blueprint and repeal or modify section 1031, how would land be treated? According to Baker, section 1031 complements the blueprint and fills in the gaps for taxpayers that would not otherwise benefit from the full expensing proposal. Like-kind exchanges allow taxpayers to engage in opportunistic transactions — such as consolidating acreage to make farming operations more efficient — without having to consider any tax consequences of what is otherwise a good business decision, she said.

"We don't have a problem with the proposals, but we see some gaps," Baker said, adding that section 1031 is "compatible and not mutually exclusive" with the blueprint proposals.

Baker said that she and other FEA representatives met in April with members of the taxwriting, Rules, and Agriculture committees, as well as other policymakers, to create awareness of the economic benefits and extensive use of section 1031 so that "they're in the best position to make fully informed decisions." ■

Zoe Sagalow contributed to this article.